

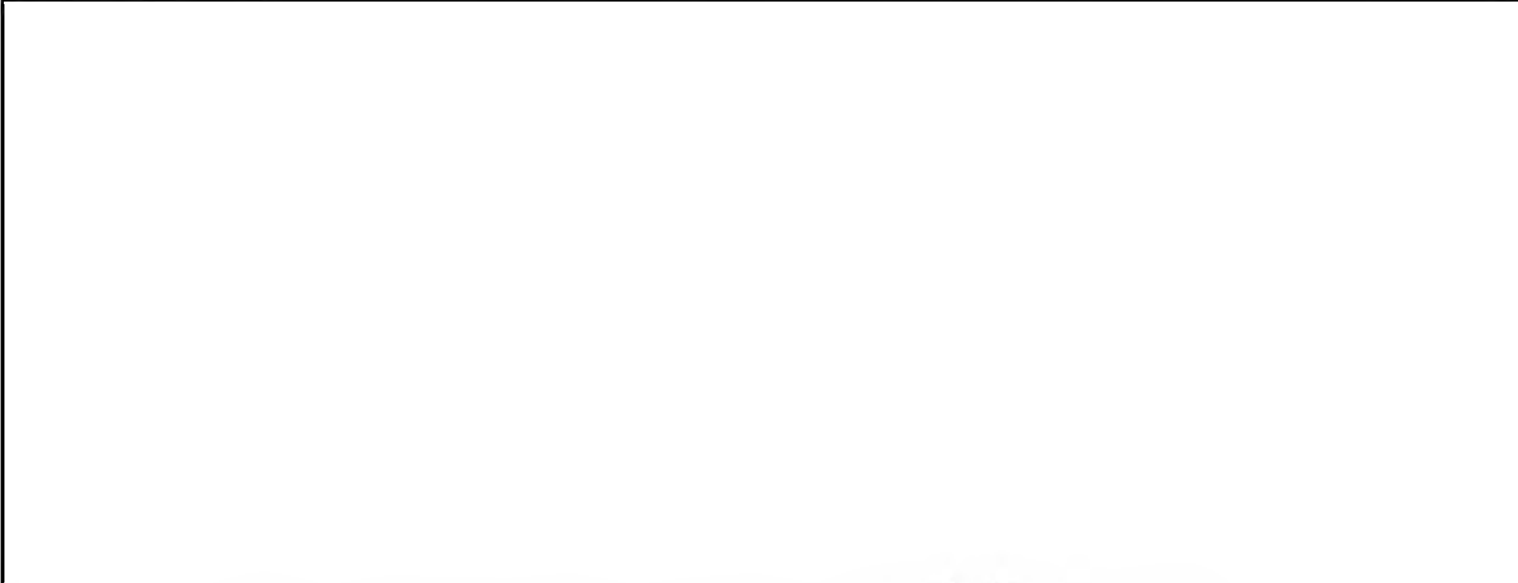
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ONE ARTICLE FROM OER'S ECONOMIC INTELLIGENCE WEEKLY REVIEW
ENDING 15 DECEMBER 1978. REQUEST ARTICLE BE PASSED TO AMBASSADOR,
DCM- ECONOMIC SECTION AND OTHER WORKING LEVEL STATE OFFICERS.



ITALY: CURRENT ACCOUNT SHOWS BIG GAINS (U)

1. THE ITALIAN CURRENT ACCOUNT BALANCE HAS MADE A
STUNNING POSITIVE SWING OF \$8 BILLION SINCE 1976, THANKS
TO DOMESTIC AUSTERITY, IMPROVED TERMS OF TRADE, A COMPETITIVE
EXCHANGE RATE POLICY, AND RECORD TOURIST RECEIPTS. THE
SURPLUSES ON CURRENT ACCOUNT HAVE BEEN USED TO REPAY DEBT
AND BUILD RESERVES TO A NEAR-RECORD LEVEL. AS INTERNATIONAL
ACCOUNTS HAVE IMPROVED, ROME HAS RELAXED ITS FOREIGN
EXCHANGE CONTROLS. (U)

2. ITALIAN GOVERNMENT ECONOMISTS VIEW THE STRONG
CURRENT ACCOUNT PERFORMANCE AS A CYCLICAL PHENOMENON
AND ARE PUSHING THE PROPOSED THREE-YEAR STABILIZATION PROGRAM,
WHICH IS INTENDED TO SLOW INFLATION FROM THE PRESENT 12-PERCENT
RATE. CRITICS CONTEND THAT A PERMANENT LOWERING OF THE
PROPENSITY TO IMPORT IS RESPONSIBLE FOR THE SURPLUS AND
ARGUE FOR A MORE EXPANSIONARY POLICY. WHILE FAVORABLE
MOMENTUM ON INVISIBLES SHOULD CONTRIBUTE TO ANOTHER STRONG
CURRENT ACCOUNT SHOWING IN 1979, HIGHER PRICES FOR IMPORTED
OIL, RISING LABOR COSTS, STOCKBUILDING, AND PROBABLE ITALIAN
PARTICIPATION IN THE EUROPEAN MONETARY SYSTEM (EMS) WILL
BE PRESSING IN THE OPPOSITE DIRECTION. (U)

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SOURCES OF SURPLUS.

3. A SHARP IMPROVEMENT IN THE TRADE ACCOUNT IS PRIMARILY RESPONSIBLE FOR THE SURGE IN ITALY'S CURRENT ACCOUNT SURPLUS THIS YEAR. DATA THROUGH JULY INDICATE THAT 80 PERCENT OF THE IMPROVEMENT WAS ACHIEVED IN NONOIL TRADE. THE JANUARY-OCTOBER TRADE SURPLUS OF \$3.0 BILLION (CUSTOMS DATA BASIS, F.O.B./F.O.B., SEASONALLY ADJUSTED) CONTRASTS WITH A MEAGER \$30 MILLION SURPLUS FOR THE LIKE PERIOD IN 1977. ON A BALANCE-OF-PAYMENTS BASIS, ITALIAN TRADE SHOULD BE CLOSE TO \$2.3 BILLION IN SURPLUS FOR ALL OF THIS YEAR. NOW THAT TRADE IS SO SUBSTANTIALLY IN THE BLACK, THE LARGE SURPLUS ON INVISIBLES, WHICH ROME HAS RELIED ON IN THE PAST TO OFFSET CHRONIC TRADE DEFICITS, GIVES THE GOVERNMENT ROOM TO MANEUVER. (U)

4. A NUMBER OF FACTORS HAVE CONTRIBUTED TO THIS YEAR'S UNPRECEDENTED CURRENT ACCOUNT SURPLUS--SOME FORTUITOUS, OTHERS POLICY INDUCED:

--GOVERNMENT STABILIZATION PROGRAMS HAVE KEPT GDP GROWTH LOW, DEPRESSING IMPORTS. IN JANUARY-SEPTEMBER 1978, IMPORT VOLUME CLIMBED ONLY 0.7 PERCENT COMPARED WITH THE SAME PERIOD IN 1977.

-- EXPORT VOLUME MEANWHILE HAS RISEN 4.6 PERCENT.

--THE COMPOSITION OF FINAL DEMAND HAS SHIFTED; INVESTMENT, WITH ITS HIGH IMPORT REQUIREMENT, HAS BEEN DEPRESSED.

--SLACK PRICES FOR OIL AND RAW MATERIAL IMPORTS HAVE CONTRIBUTED TO AN IMPROVEMENT IN THE TERMS OF TRADE; THIS ACCOUNTS FOR MORE THAN ONE-THIRD OF THE TRADE SURPLUS IN 1978. DURING THE FIRST NINE MONTHS OF THIS YEAR, EXPORT PRICES WERE UP 0.5 PERCENT IN DOLLARS FROM THE LIKE PERIOD OF 1977, WHILE IMPORT PRICES INCREASED ONLY 8.1 PERCENT.

--ROME HAS PURSUED A COMPETITIVE EXCHANGE RATE POLICY. THE CIA TRADE-WEIGHTED, PRICE-ADJUSTED EXCHANGE RATE INDEX FOR ITALY (A DEVICE FOR TRACKING THE INTERNATIONAL PRICE-COMPETITIVENESS OF ITALIAN MANUFACTURED GOODS)

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HAS FALLEN CONTINUOUSLY SINCE YEAREND 1976, INDICATING IMPROVEMENT IN THEIR COMPETITIVE POSITION. ITALIAN MANUFACTURERS ARE MAINTAINING THEIR WORLD MARKET SHARE NEAR ITS ALL-TIME HIGH.

--FLOCKS OF TOURISTS FROM NORTHERN EUROPE, ENCOURAGED BY A BARGAIN LIRA, ARE SEEKING THE ITALIAN SUN. DESPITE THE BAD PRESS GENERATED BY TERRORIST ATTACKS, TOURIST SPENDING WILL REACH \$5.8 BILLION THIS YEAR, UP FROM \$3.9 BILLION IN 1977. (U)

USES OF CURRENT ACCOUNT SURPLUS.

5. ITALY HAS ACCUMULATED ALMOST \$7.5 BILLION IN CURRENT ACCOUNT SURPLUSES OVER THE LAST TWO YEARS. THE MONEY HAS BEEN USED PRIMARILY TO REPAY MEDIUM-TERM DEBT AND TO BUILD UP RESERVES. (U)

6. ROME HAS BEEN SADDLED WITH HEAVY MEDIUM- AND LONG-TERM DEBT, MUCH OF IT OFFICIAL BORROWING TO COVER BALANCE-OF-PAYMENTS DEFICITS IN 1974-76. AT YEAREND 1977, ITALY'S GROSS MEDIUM- AND LONG-TERM HARD CURRENCY DEBT (PUBLIC AND PRIVATE) TOTALLED \$20.8 BILLION, EXCEEDING FOREIGN ASSET HOLDINGS BY \$5.5 BILLION. (U)

7. THE DEBT SERVICE BURDEN ROSE SUBSTANTIALLY IN 1978, WITH NET PRINCIPAL REPAYMENTS OF \$2.4 BILLION (\$5 BILLION GROSS) FALLING DUE. NEVERTHELESS, THE CURRENT ACCOUNT SURPLUS HAS ALLOWED REPAYMENTS TO BE MADE PUNCTUALLY. ITALY, IN FACT, HAS MADE A NUMBER OF PAYMENTS AHEAD OF SCHEDULE AS PART OF AN ONGOING CAMPAIGN TO RESTORE ITS INTERNATIONAL CREDIT STANDING. THE \$2 BILLION 'GOLD-BACKED' CREDIT FROM THE BUNDESBANK WAS SETTLED IN JULY BY EARLY REPAYMENT OF THE \$1 BILLION BALANCE. ALSO SETTLED AHEAD OF THE DUE DATE WAS THE 1974 \$1.4 BILLION EC STANDBY LOAN. A \$1.2 BILLION INTERNATIONAL MONETARY FUND STANDBY WAS THE THIRD MAJOR LOAN PAID OFF THIS YEAR, WITH A FINAL INSTALLMENT OF \$300 MILLION. (U)

8. ITALY HAS ALSO BEEN USING SURPLUS EARNINGS TO REBUILD RESERVES. AS OF OCTOBER, OFFICIAL RESERVES STOOD

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CLOSE TO AN ALLTIME HIGH AT \$14.1 BILLION. IN THE 12 MONTHS SINCE OCTOBER 1977, HOLDINGS OF CONVERTIBLE FOREIGN EXCHANGE GREW 28 PERCENT TO STAND AT \$9.6 BILLION. (U)

DISMANTLING EXCHANGE CONTROLS.

9. WITH THE CURRENT ACCOUNT IMPROVING, ITALY LAUNCHED A SERIES OF MOVES TO EASE EXCHANGE CONTROLS. IN EARLY 1977, ROME ABOLISHED THE TAX ON FOREIGN EXCHANGE PURCHASES AND THE IMPORT DEPOSIT SCHEME UNDER WHICH IMPORTERS HAD BEEN COMPELLED TO DEPOSIT A PORTION OF FOREIGN EXCHANGE PURCHASES IN NONINTEREST BEARING ACCOUNTS AT THE BANK OF ITALY. IN OCTOBER 1977, THE REINS WERE LOOSENEED ON SPENDING BY ITALIAN TOURISTS; AN ITALIAN IS NOW ALLOWED TO SPEND \$880 ABROAD EACH YEAR INSTEAD OF \$585. AT THE SAME TIME, THE BAN ON THE EXPORT OF LOWER DENOMINATION LIRA BANK NOTES WAS ABOLISHED. (U)

10. IN JUNE 1978 THE REQUIREMENT THAT ITALIAN EXPORTERS OBTAIN FOREIGN EXCHANGE FINANCING FOR 25 PERCENT OF SHORT-TERM CREDITS WAS ELIMINATED. IN NOVEMBER THE TIME LIMIT FOR THE CONVERSION OF FOREIGN EXCHANGE EARNINGS INTO LIRE WAS EXTENDED. ALSO, THE FOREIGN EXCHANGE OFFICE EASED RESTRICTIONS ON FORWARD PURCHASES OF FOREIGN CURRENCY. PEEVED WITH THE ITALIAN PENCHANT FOR SLAPPING ON EXCHANGE CONTROLS WHENEVER THE LIRA IS THREATENED, ITALY'S EC PARTNERS HAVE GREETED ROME'S EASING OF RESTRICTIONS WITH RELIEF. (C)

11. ONE DOMESTIC MONETARY CONTROL WITH INTERESTING BALANCE-OF-PAYMENTS IMPLICATIONS IS THE TIGHT CEILING THE BANK OF ITALY HAS IMPOSED ON DOMESTIC CREDIT EXPANSION BY COMMERCIAL BANKS. WHEN UNABLE TO OBTAIN LIRA CREDIT, ITALIAN BORROWERS PRESS THEIR BANKS TO ARRANGE LOANS IN FOREIGN EXCHANGE. LAST YEAR, THE NET FOREIGN INDEBTEDNESS OF ITALIAN BANKS ROSE ABOUT \$3.5 BILLION; THIS SHORT-TERM CAPITAL INFLOW ACCOUNTED FOR ABOUT 60 PERCENT OF THE 1977 GROWTH IN CENTRAL BANK RESERVES. IN THE FIRST 10 MONTHS OF 1978 THE NET FOREIGN INDEBTEDNESS OF THE BANKS DEELINED ABOUT \$600 MILLION, MAINLY DUE TO SHIFTS IN INTEREST RATE DIFFERENTIALS. (C)

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FEEDBACK ON DOMESTIC POLICY.

12. THE GYRATIONS IN ITALY'S FOREIGN ACCOUNTS TRADITIONALLY HAVE BEEN EXPLAINED AS RESULTING FROM AN INVENTORY STOCK CYCLE. ABOUT 60 PERCENT OF ITALY'S IMPORTS CONSIST OF OIL, RAW MATERIALS, AND SEMIFINISHED GOODS--THE COMMODITIES THAT MAKE UP THE INPUT INVENTORIES OF THE INDUSTRIAL SECTOR. IN TIMES OF GOVERNMENT-INDUCED CONTRACTION, FIRMS SLASH THEIR IMPORTS, BRINGING RELIEF TO THE FOREIGN ACCOUNTS. ECONOMIC RECOVERY, IN TURN, IS OFTEN ACCOMPANIED BY SPECULATIVE IMPORT BUYING AS MANUFACTURERS STOCK UP IN ANTICIPATION OF LIRA DEPRECIATION AND HIKES IN IMPORT PRICES. (U)

13. GOVERNMENT PLANNERS TREAT THE STRONG CURRENT ACCOUNT PERFORMANCE AS A CYCLICAL PHENOMENON. THEY REASON THAT AUSTERITY MEASURES HAVE SLOWED IMPORT GROWTH AND THAT A FIRMER LIRA AND HIGHER INTEREST RATES HAVE DISCOURAGED SPECULATIVE STOCKPILING. WHEN VIEWED IN THIS MANNER, THE SURPLUSES APPEAR TRANSITORY. AS SOON AS THE GOVERNMENT RELEASES THE FINANCIAL BRAKES, AN IMPORT BUYING SPREE WOULD SWING THE TRADE ACCOUNT ONCE AGAIN INTO THE RED. WAGE AND PUBLIC FINANCE REFORM ARE NEEDED, GOVERNMENT ECONOMISTS CONTENT, BEFORE ITALY CAN ATTAIN STABLE GROWTH. (U)

14. IN RECENT MONTHS, A STUDY PUBLISHED BY AN ITALIAN BANK (CREDITO ITALIANO) HAS TOUCHED OFF CRITICISM OF THE GOVERNMENT'S ANALYSIS. THE CRITICS ARGUE THAT THE TURNAROUND IN ITALIAN FOREIGN ACCOUNTS HAS BEEN TOO SHARP AND TOO PROLONGED TO BE EXPLAINED BY CYCLICAL FORCES. THEY MAINTAIN THAT A STRUCTURAL SHIFT HAS OCCURRED, A PERMANENT LOWERING OF THE PROPENSITY TO IMPORT. ACCORDING TO THIS LINE OF REASONING, BUSINESS FIRMS HAVE DEVELOPED IMPORT SUBSTITUTION MEASURES AND HAVE SWITCHED TO ENERGY-SAVING PRODUCTION TECHNIQUES. BACKERS OF THE SECOND THEORY CONTENT THAT ITALY HAS BEEN MORE SUCCESSFUL THAN OTHER MAJOR INDUSTRIAL COUNTRIES IN THIS ADAPTATION PROCESS DUE TO GREATER RELIANCE ON SMALL, FLEXIBLE FIRMS. SINCE THE IMPROVEMENT IN THE FOREIGN ACCOUNTS IS HERE TO STAY--THESE DISSENSERS ARGUE--THE GOVERNMENT HAS AMPLE FREEDOM TO REFLATE. (U)

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15. AVAILABLE DATA ARE SUFFICIENT TO CONFIRM OR REFUTE THE STRUCTURAL-SHIFT THEORY. ECONOMETRIC TESTS HAVE PRODUCED INCONCLUSIVE RESULTS. NONETHELESS, THE THEORY HAS GIVEN POWERFUL INTELLECTUAL AMMUNITION TO OPPONENTS OF THE GOVERNMENT'S STABILIZATION PROGRAM. INDUSTRIALISTS ARE ADVOCATING A RETURN TO FAST GROWTH THROUGH THE DIVERSION OF SOME AVAILABLE FOREIGN EXCHANGE FROM RAPID DEBT REPAYMENT TO FINANCE IMPORTS OF CAPITAL GOODS AND INDUSTRIAL MATERIALS. SIMILARLY, THE UNIONS ARE INSISTING THAT ROME NOT FOLLOW THE WEST GERMAN PRACTICE OF ACCUMULATING EXCHANGE RESERVES. THEY ESPECIALLY FAVOR MORE SPENDING TO FINANCE JOB-CREATING INVESTMENT AND ECONOMIC DEVELOPMENT IN THE MEZZOGIORNO. (U)

16. TREASURY MINISTER FILIPPO PANDOLFI--AUTHOR OF THE THREE-YEAR PLAN FOR THE GRADUAL ECONOMIC ALIGNMENT OF ITALY WITH THE REST OF EUROPE--RECOGNIZES THE IRONY OF HIS PRESENT SITUATION. THE AUSTERITY MEASURES PANDOLFI SPONSORED IN 1976-77 HAVE SUCCEEDED SO WELL IN RECTIFYING ITALY'S INTERNATIONAL PAYMENTS SITUATION THAT SOME OF THE PRESSURE FOR SEEKING LONGER TERM SOLUTIONS TO INFLATION/GROWTH PROBLEMS HAS DISSIPATED. ENACTMENT OF HIS NEW PLAN WILL REQUIRE DIFFICULT CHOICES BY ALL THE POLITICAL PARTIES. HISTORICALLY, FOREIGN EXCHANGE CRISES HAVE BEEN THE ONLY STIMULI POTENT ENOUGH TO TURN THE ATTENTION OF ITALIAN LEADERS AWAY FROM POLITICAL MACHINATIONS AND TOWARD ECONOMIC REFORM. (C)

OUTLOOK: ANOTHER GOOD YEAR.

17. THE ITALIAN CURRENT ACCOUNT SHOULD MAKE ANOTHER STRONG SHOWING IN 1979. SLIPPAGE ON TRADE ALMOST CERTAINLY WILL BE OFFSET BY GAINS ON INVISIBLES, WITH TOURIST RECEIPTS CONTINUING TO RISE. (U)

18. AS THE ECONOMY PICKS UP, IMPORT VOLUME--PROPELLED BY INVENTORY BUILDUPS--IS LIKELY TO REGISTER A SIZABLE INCREASE. A RISE IN OPEC OIL PRICES WILL HIKE THE OIL IMPORT BILL. NEW LABOR CONTRACTS SLATED TO BE NEGOTIATED THIS WINTER FOR MORE THAN FIVE AND ONE-HALF MILLION WORKERS WILL BRING HIGHER WAGES AND PROBABLY SHORTER HOURS. IN THE

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SHORT RUN, AS NEGOTIATIONS BECOME MORE HEATED, STRIKES AND WORKER RALLIES ARE LIKELY TO MULTIPLY, CAUSING A REDUCTION IN OUTPUT AND EXPORTS AND A SWITCH TO NON-ITALIAN SOURCES OF SUPPLY. FURTHERMORE, THE GOVERNMENT'S CONTINUED INABILITY TO STEM INCREASES IN TRANSFER PAYMENTS TO STATE ENTERPRISES, LOCAL GOVERNMENTS, AND WELFARE GROUPS WILL ADD FUEL TO INFLATION. IN SHORT, SOME EROSION OF ITALIAN EXPORT COMPETITIVENESS APPEARS UNAVOIDABLE IN THE ABSENCE OF LIRA DEPRECIATION. (C)

19. PARTICIPATION IN THE PROPOSED EUROPEAN MONETARY SYSTEM (EMS), WHICH WILL TIE THE LIRA TO THE FRENCH FRANC AND THE CURRENCIES ALREADY IN THE EUROPEAN JOINT FLOAT, COULD ALSO HAVE A NEGATIVE EFFECT ON NEXT YEAR'S CURRENT ACCOUNT PERFORMANCE. IN RECENT YEARS, ITALY HAS BEEN ABLE TO PRESERVE EXPORT COMPETITIVENESS BY ALLOWING THE LIRA TO DEPRECIATE AGAINST THE CURRENCIES OF MOST TRADING RIVALS. FOR EXAMPLE, THE LIRA HAS LOST MORE THAN HALF ITS VALUE AGAINST THE DEUTSCHE MARK SINCE MARCH 1973, WHEN THE SMITHSONIAN SYSTEM OF EXCHANGE RATE PARITIES WAS ABANDONED. (C) (CONFIDENTIAL) RVW 15 DEC 98 DRV MULTIPLE BY 015319 WNINTEL.>

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